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SUBJ: PAKISTAN'S ECONOMIC PERFORMANCE IMPROVING, BUT STRUCTURAL

REFORMS INSUFFICIENT FOR IMF

REF: A. ISLAMABAD 2698
¶B. ISLALAMABD 1992

¶1. (SBU) Summary: Pakistan's macroeconomic outlook was mixed in the first quarter of the fiscal year 2009-2010. While its year-on-year inflation and balance of payments position improved, fiscal and real sector performance remained tenuous. Lending to the private sector declined, but the external current account balance improved slightly, a result of the emerging global economic recovery. But continued electricity shortages, limited progress on power sector reforms, and ongoing fiscal stresses diluted some of these gains. Although the International Monetary Fund (IMF) recognized GOP efforts to further stabilize the economy, advance structural reform and lay the foundations for sustainable growth, doubts about GOP commitment to further electricity tariff increases and concerns with delays in enacting meaningful tax reform, have outweighed progress. The November 12 conclusion of the third review of Pakistan's performance under its Stand-By Arrangement with the Fund has not resulted in the hoped for disbursement of the third tranche of funds for the GOP, although discussions will continue. End Summary.

¶2. (U) Private sector credit growth was down: $938 million in the first quarter, compared to $978 million in the same period last year. The growth rate for the large scale manufacturing sector, however, although virtually flat at 0.17 percent in July-August 2009, is being viewed as a marked improvement over the -8.1 percent growth in the same period last year. Advisor to the Minister of Finance Sakib Sherani said the manufacturing growth rate had been pulled down by the poor performance of the steel and petroleum sectors (affected by the poor performance of Pakistan Steel Mills and circular debt, respectively).

Cautious Optimism for the Economy

¶3. (SBU) Sherani said there are grounds for cautious optimism for the Pakistani economy. The textile sector (despite much industry outcry to the contrary) recorded marginal improvement, while the automobile sector had been boosted by strong performance in agriculture: farmers and workers in related industries had sufficient funds to acquire automobiles and trucks, despite banks' reluctance to finance these purchases. Domestic cement sales indicate an uptick in construction activity and offset lower orders from abroad, particularly from India.

¶4. (U) According to a survey on business sentiment conducted by the Pakistan Institute of Development Economics (PIDE), 60 percent of major business concerns expect higher sales, increased capacity

utilization, and higher employment and inventory levels in July-December 2009. These businessmen named slack demand as the number one impediment to their business; the high cost of capital was second on their list of concerns, followed by security and then the energy shortage. Small and medium businesses, however, suffer most from energy shortages, according to Sherani. Although the recent bombings and general deterioration in the overall security situation have badly affected FATA and NWFP businessmen, Sherani said that bombings have had less effect on business sentiment countrywide.

FDI Down, Portfolio Investment Up

¶5. (SBU) Foreign direct investment (FDI) decreased by 58.8 percent to $463 million in the first quarter FY 2009-2010, down from $ 1.1 billion in the same period last year. According to the PIDE business survey, the majority of firms reported an unchanged level of investment in their businesses from January-June 2009 and they did not plan any significant investment in July-December 2009. Major portfolio investment outflows were reversed from an outflow -$172.9 million to an inflow of $208 million in the first quarter: a 220 percent increase. The Finance Ministry ascribes this turnaround to attractive stock valuations in comparison to other countries in the region and an upgrade in Pakistan's debt by international rating agencies (Ref A).

Imports Down, Remittances Up

¶6. (SBU) Weak demand caused Pakistan's total imports to decline from $10.8 billion in the first quarter of FY 2008-2009 to $7.58 billion

in the same period this year, a 29.8 percent drop, and contributing to a 44.7 percent decrease in Pakistan's trade deficit compared to last year. Supported by the continued strong inflow of worker's remittances, this fall in import growth has resulted in an $82 million surplus in the external current account balance in August ¶2009. The cumulative July-August external current account deficit of $527 million is still much lower than $2.67 billion deficit in the same period last year. Workers' remittances increased by 24.5 percent to $2.33 billion in the first quarter, from $1.87 billion in the same period last year. Remittances in September 2009 alone totaled a record $806 million. Sherani ascribed the steady increase to GOP measures such as a crackdown on illegal money changers (Ref B).

Exports Expected to Increase

¶7. (SBU) Sherani also pointed out that the 13.8 percent decline in exports in the first quarter is worrisome and continues to pose an underlying risk to Pakistan's balance of payments. The GOP expects exports to grow at a rate of 3-4 percent in FY 2009-2010, however, because order books for the textile firms "looked very healthy," reflecting improvements in the global economy; order books for the spinning sector are fully booked for the next six months. Improvements in spinning sector performance in turn bode well for the health of the banking sector, Sherani said, because spinners are major borrowers and can add to banks' bad debt if the sector's performance falters. Finally, depreciation of Pakistan's real effective exchange rate, due to falling domestic inflation and an appreciation of India's currency, has increased the competitiveness of Pakistani exports.

ForEx Improves

¶8. (U) Cash injections from the IMF, both for budgetary support ($745 million) and the increased allocation of special drawing rights (some $1.2 billion), substantially improved Pakistan's external financial account balance. As a result, SBP's foreign exchange reserves reached $10.9 billion on September 28, 2009 - an increase of $1.8 billion since July 1. This is also reflected in the $1.58 billion increase in net foreign assets, which contributed

to the economy's improved liquidity and brought stability to foreign exchange markets. Despite an impressive drop in credit default swaps from 30 to 8 percent, Pakistan's rate (Note: On par with Argentina. End Note) is still high for it to raise money through the Eurobond markets.

But Revenue Collection Is Still Too Low

¶9. (SBU) Tax collection is down by 0.95 percent to $3.12 billion in the first quarter, from $3.15 billion in the same period last year, further complicating fiscal management, according to Sherani. He was hopeful that shortfalls in collection could be made up in coming quarters, however, because first quarter collection is based on FY 2008-2009 corporate profits and incomes - all of which were low due to the economic slowdown. The GOP blames slower than expected disbursements from donor countries for the fiscal challenges - both revenues and expenditures -facing the Finance Ministry.

Borrowing Is Down - Or Is It?

¶10. (U) Pakistan's fiscal deficit was 1.5 percent of GDP in the first quarter, marginally higher than the IMF-agreed target of 1.3 percent. Sherani said the slight slippage on the fiscal deficit was not a cause for concern, as the GOP had had to make advance salary payments on the occasion of the post-Ramazan Eid holiday. The government also retired $882 million-worth of debt to the State Bank of Pakistan during July 1-October 3 in order to meet the IMF zero net borrowing condition. However, the GOP borrowed extensively from commercial banks: some $1.4 billion during July-September 2009, vs. the retirement of $1.27 billion-worth of commercial debt in the same period last year. This borrowing crowded out private sector credit, which fell by $940 million in the first quarter.

Good News on Inflation

¶11. (SBU) Both consumer price inflation (CPI) and core inflation (non-food, non-energy inflation) decreased in July-September 2009. CPI dropped to 10.7 percent and core inflation fell to 12.9 percent, down from 24.5 percent and 16.1 percent respectively in the same period last year. Despite this positive news, former Advisor to the Minister of Finance and now Dean of the National University of Science and Technology Dr. Ashfaque Khan pointed out that the pace of decline in inflation has been slow. Furthermore, a 0.5 percent increase in inflation in September over August, coupled with poor management of the food supply chain (Note: leading to shortages of such staples as sugar and wheat. End Note) and projected increases in electricity prices could well fuel higher inflation in coming months. Unpredictable increases in international oil prices were also an underlying risk to inflation as well. In response to ongoing concern about inflation, the State Bank kept the policy rate unchanged at 13 percent in its October monetary policy announcement.

Not Enough for the IMF?

¶12. (SBU) Working level contacts in the Ministry of Finance and the IMF/Islamabad office reported November 13 that the IMF has registered concern over the slow pace of agreed structural reforms, especially the slow pace of tax reforms and imposition of a value added tax (VAT), at the third review under Pakistan's Stand-By Arrangement (SBA) in Dubai November 2-12. Tasnim Aslam, Senior Economist at the IMF, said that the lack of progress on tax reforms has resulted in a revenue shortfall in the first quarter of the current fiscal year. The IMF team in Dubai also expressed concern about the GOP failure to implement the automatic fuel adjustment mechanism, which will more effectively pass on changes in fuel prices to electricity consumers.

¶13. (SBU) Comment: Sherani's predictions that Pakistan would have an easier time in its third review than it had in its second (Note:

which dragged on for over a month. End Note) do not appear to be borne out. The GOP hoped making changes in the Banking Companies Ordinance and SBP Act to enhance the Bank's autonomy (Note: The Act is currently with the National Assembly. End Note), coming in more or less on the mark with the fiscal deficit target, and in particular implementing the six percent electricity tariff increase would outweigh Pakistan's shortcomings. However, the Fund's concern with the GOP's inability to move forward with meaningful tax reform and to collect taxes already levied seem to have prevailed; the conclusion of the third review has been suspended from its scheduled November 12 date (septel). Continued doubts about the GOP commitment to further increases in electricity tariffs (Note: two more increases are due in the next six months. End Note) also contribute to the Fund's caution. Minister of Finance Shaukat Tarin told media November 13, however, that he expected Pakistan's third tranche of funds to be released "soon."

¶14. (SBU) Comment cont'd: Uncertainty regarding the timing of official foreign inflows, continued pressure on the country's fiscal management and limited progress on resolution of Pakistan's serious electricity problems remain a drag on economic growth and stability. If expectations of a recovery in at least some exports are mistaken, the low export figures will constitute a major threat to the country's balance of payments; low imports are already having an adverse effect on revenue, as 40 percent of GOP revenue income comes from import taxes. Instituting a value added tax (VAT), essential to improving Pakistan's dismal 9 percent tax-to-GDP ratio, is making only slow progress in the face of thorny constitutional issues requiring federal and provincial government agreement. End Comment.